Survival of the Fittest

[clauses]

Drafting and Enforcement of Contractual Limitations Periods Utilizing Delaware's Amended Statute of Limitations

by Kevin G. Hunter

Merger and acquisition agreements involving privately-held companies, as well as many other commercial contracts, often include terms providing for the "survival" of specified representations, warranties, and covenants, including indemnity obligations. In the case of representations[1] contained in M&A agreements (and related claims for indemnity based upon breach of such representations), the representations are often grouped into various "survival buckets" based upon their perceived relative importance and the length of time in which problems can potentially arise after closing. For example, so-called "fundamental" representations (e.g., authority to contract; title to shares or assets) often survive "indefinitely" or have no specified expiration date. The survival period of representations relating to tax or regulatory matters is often tied to the expiration of the "applicable statute of limitations." Other general or uncategorized representations typically survive for a stated period, usually anywhere from six months to four years.

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The survival period of representations is often negotiated very heavily, sometimes even at the letter of intent stage. The buyer generally wants an adequate period of time after the closing in which to identify problems with the target company not discovered during the due diligence process, while the seller wants to bring finality to its continuing liability exposure as quickly as possible. In negotiating these survival provisions, however, counsel representing both buyers and sellers often fail to consider the impact that state-enacted statutes of limitations, and courts' application of such statutes of limitations, have on the parties' ability to rely on and enforce these provisions.

I Will Survive (The Closing)—But For How Long?

Consider the following provision included in an M&A agreement: *The representations in this Agreement will survive the closing for a period of one year, except that (1) the representations in Section X will survive the closing for a period of four years, (2) the representations in Section Y will survive indefinitely, and (3) the representations in Section Z will survive until the expiration of the applicable statute of limitations.* The foregoing, or a similar provision, is almost always included in an M&A agreement in order to preserve the parties' rights to pursue remedies for breach of representations following the closing of the transaction. Without a survival clause, the representations in the agreement expire at closing and no remedy may be sought or obtained against the breaching party after the closing.[2] Although most counsel will profess to understand the intent and effect of this survival clause, courts have interpreted nearly identical survival clauses in very different ways, often leading to disparate, unintended results.

As noted, the parties in an M&A transaction typically include in their agreement one or more stated time periods during which claims for breach of representations, and related claims for indemnity, must be asserted or brought. Such a provision, commonly referred to as a "contractual limitations period," rarely coincides with the applicable statute of limitations period. Rather, such clauses are often construed by the courts to constitute attempts—sometimes unintended—to either lengthen or shorten the applicable statute of limitations.

In almost all jurisdictions, courts have consistently held that public policy dictates that the parties to a contract cannot *lengthen* the survival period for claims beyond the period specified in the statute of limitations.[3] This is true even in Delaware, where the statute of limitations for actions arising under contract is three years.[4] Thus, even if the parties specify a longer period of time in their agreement, a lawsuit for breach of representations under a contract to which the Delaware statute of limitations applies must be brought within three years from the closing date since most causes of action for breach of a representation will be deemed to have arisen as of the closing.[5] Using our example above, the survival period applicable to the representations in Sections X and Y will be limited to three years from closing, despite the parties' apparent intent otherwise, and the representations in Section Z will survive for a maximum of three years assuming Delaware's general statute of limitations is applicable.

On the other hand, public policy generally permits the parties to a contract to *shorten* the applicable statute of limitations for breach claims by means of a contractual limitations provision, although the legal standards and criteria for doing so seem to vary among jurisdictions. In Delaware, for example, a statement in a contract that certain representations will "survive for a period of one year after the closing" has been held to be an "unambiguous one-year limitations period" requiring that any action for breach of such provision be commenced within one year after closing.[6] However, courts in California and New York have found substantially identical language to be ambiguous and subject to multiple interpretations and therefore ineffective as an attempt to create a contractual limitations period.[7] Rather, such language merely serves "to specify when a breach of the representations and warranties may occur, but not when an action must be filed."[8]

In Arizona, there is a dearth of case law on the enforceability of contractual limitations periods, whether they be attempts to lengthen or shorten the statutory period.[9] In all likelihood, Arizona would join with the vast majority of other jurisdictions that have held that contractual attempts at lengthening the statute of limitations period are unenforceable. In the case of efforts to shorten the statutory period, Arizona appears to follow California law. In *Automotive Holdings, L.L.C. v. Phoenix Corner Portfolio, L.L.C.*, Judge Teilborg held, in the context of the purchase and sale of real property where the purchase agreement provided that the "'covenants, representations and warranties of Buyer and Seller set forth in this agreement shall survive … the Close of Escrow for a period of one year,'" that such provision did not "expressly limit the statute of limitations to a period of one year" and must be interpreted merely as limiting "the time when a breach of the representations may have occurred, not the period of time in which Plaintiff was required to file suit."[10]

But We Chose Delaware Law!

The foregoing discussion assumes that the parties' express choice of law will determine the applicable statute of limitations. But that is not necessarily the case. Which jurisdiction's statute of limitations applies is a procedural, as opposed to substantive, issue for choice of law purposes.[11] As such, if the parties elect Delaware as the governing law but for convenience purposes select California as the venue for dispute resolution, the California court considering such dispute will likely look to its own procedural rules for determining the applicable statute of limitations in connection with breach of contract claims. It is therefore imperative that counsel consider the likely venue for any claims arising under the agreement when considering the survival and statute of limitations issues described above. Alternatively, it may be possible to specify a particular jurisdiction's statute of limitations as applicable to claims arising under the agreement, but it is uncertain whether a court would respect such election given the inherently procedural nature of the issue.

Break Out the Corporate Seal

Given Delaware's relatively short statute of limitations period, M&A counsel have sought for ways to give effect to their clients' desires, in many situations, for longer periods in which to assert claims for breach of representations under an M&A agreement. Unfortunately, the only semi-reliable method of effectively extending the claims period beyond the three-year statutory period in Delaware is to cause the agreement to be executed under seal.[12]

Under Delaware common law, contracts executed "under seal" have a limitations period of 20 years.[13] If the proper steps are taken to cause a contract to be executed under seal, the statute of limitations is effectively extended for all claims under the contract up to 20 years and the risk of survival periods expiring before their stated end date can be effectively mitigated. Unfortunately, since executing a contract under seal is a common law (and arcane) construct with very little helpful case law, there is significant uncertainty with respect to the procedures necessary to effectively execute a contract under seal and therefore the practice has never been widely or effectively embraced or relied upon.[14]

Delaware to the Rescue—Again!

The Delaware legislature—in its continuing effort to further its stated public policy of promoting freedom of contract—enacted an amendment to Delaware's statute of limitations in 2014 (the "Limitations Amendment") that, if properly utilized, will allow counsel to buyers and sellers in M&A transactions and other commercial arrangements to ensure that the contracting parties' desires with respect to survival of contractual obligations are fully realized.[15]

The Limitations Amendment provides:

> (c) Notwithstanding anything to the contrary in this chapter (other than subsection (b) of this section [dealing with property insurance contracts]) or in § 2-725 of Title 6 [dealing with sales of goods under the Uniform Commercial Code], an action based on a written contract, agreement or undertaking involving at least $100,000 may be brought within a period specified in such written contract, agreement or undertaking provided it is brought prior to the expiration of 20 years from the accruing of the cause of such action.

The Limitations Amendment allows the parties to an agreement involving at least $100,000 to specify the survival period for any contractual provision—up to a maximum of 20 years. The Limitations Amendment also allows for great latitude in determining how a survival period is structured or determined—it could be a certain time period following the closing, it could be a time period tied to the occurrence of some other event (e.g., the issuance of the company's next annual audited financial statement), or it could be indefinite (but subject in any event to the 20-year outside limitation).

Although the Limitations Amendment is intended to provide maximum flexibility to parties entering into commercial agreements in structuring survival clauses, counsel should nevertheless be careful to properly draft survival provisions that are intended to utilize the Limitations Amendment. For example, it is not clear that simply stating that a contractual provision survives until "the expiration of the applicable statute of limitation" would be sufficient to obtain the benefit of the 20-year maximum period. A court might interpret such a statement as simply referring to Delaware's general three-year limitations period, or some other potentially applicable statute of limitations. Therefore, until common practices are widely adopted by legal practitioners and recognized by the courts, a careful practitioner may want to make express reference to the Limitations Amendment when drafting survival provisions under Delaware law to ensure that the Limitations Amendment is properly applied. Further, a well-drafted survival clause will clearly specify whether the clause is intended as a true contractual limitations provision, thus establishing the period during which legal action must be formally commenced, or whether the clause is simply intended as a notice provision establishing the time period during which a claim must be "noticed" or formally asserted against the breaching party (but which will be subject to the applicable statute of limitations for the initiation of legal action in any event).[16]

With the enactment of the Limitations Amendment, Delaware has once again demonstrated its willingness to accommodate the needs of the business community. The coupling of the Limitations Amendment with a well-drafted survival clause should enable practitioners to ensure that their clients' expectations regarding the enforcement of contractual obligations after closing will be respected. Further, unless other states follow suit with similar amendments to their statutes of limitations, Delaware will have an additional advantage over New York and other states as the "go to" jurisdiction for choice of law in M&A transactions. abl

[ENDNOTES]

1. Although there are legal distinctions between representations, on the one hand, and warranties, on the other hand, such distinctions are unimportant for purposes of this article. For ease of reference, this article will only use the term "representations."
2. *See Western Filter Corp. v. Argan, Inc.*, 540 F.3d 947, 952 (9th Cir. 2008) ("Unless the parties agree to a survival clause—extending the representations and warranties past the closing date—the breaching party cannot be sued for damages post-closing for their later discovered breach.").
3. *GRT, Inc. v. Marathon GTF Technology, Ltd.*, 2011 WL 2682898 at *15 (Del. Ch. July 11, 2011) (see, in particular, footnote 80).
4. 10 Del. C. § 8106(a). The statute of limitations is four years for claims arising under Article 2 of the Delaware Uniform Commercial Code. 6 Del. C. § 2-725.
5. *See Cent. Mortgage Co. v. Morgan Stanley Mortgage Capital Holdings LLC, 2012 WL 3201139* at *17 (Del. Ch. Aug. 7, 2012); *cf. CertainTeed Corp. v. Celotex Corp.*, 2005 WL 217032 at *14 (Del. Ch. Jan. 24, 2005) (distinguishing between "direct" claims, which begin to accrue as of closing, and common law third-party indemnity claims, which begin to accrue as of the date the claim is paid to the third party claimant). In Delaware, until the enactment of the Limitations Amendment as discussed herein, to enforce a claim for breach of a representation more than three years after the closing the plaintiff had to establish that (i) the cause of action arose at a later date, (ii) the statute of limitations was tolled, or (iii) the contract was executed under seal.
6. *GRT, Inc.* at *12. *See also ENI Holdings, LLC v. KBR Group Holdings, LLC*, 2013 WL 6186326 at *7 (Del. Ch. Nov. 27, 2013).
7. *See Western Filter Corp.* at 953-54 (holding that a provision stating that representations "shall survive the Closing for a period of one year" is ambiguous and insufficient to demonstrate the parties' intent to create a contractual limitations period); *Hurlbut v. Christiano*, 63 A.D.2d 1116, 405 N.Y.S.2d 871 (N.Y.App.Div. 1978).
8. *Western Filter Corp.* at 954.
9. The Arizona statute of limitations for actions arising under a written contract is six years. A.R.S. § 12-548.A.1.
10. *Automotive Holdings, L.L.C. v. Phoenix Corner Portfolio, L.L.C.*, 2010 WL 1781007 at *3 (D. Ariz. May 4, 2010).
11. *Cent. Mortgage Co.* at *16.
12. Other, even less reliable, options for extending the Delaware statute of limitations beyond three years after closing are listed in note 5 *infra*.
13. *State v. Regency Group, Inc.*, 598 A.2d 1123, 1129 (Del. Super. 1991).
14. The procedures for execution of a contract under seal by an individual appear to be fairly settled. That is not the case, however, for corporations. *See, e.g., Whittington v. Dragon Group, L.L.C., et al.*, 991 A.2d 1, 10 (Del. 2009) ("[W]e hold that in Delaware, in the case of an individual, in contrast to a corporation, the presence of the word "seal" next to an individual's signature is all that is necessary to create a sealed instrument….").
15. 10 Del. C. § 8106(c). The Limitations Amendment became effective as of August 1, 2014.
16. Courts have consistently held that a contractual limitations provision cannot be utilized to circumvent the applicable statute of limitations. A party cannot give notice of a claim and then sit on the claim indefinitely without bringing suit; a lawsuit must still be brought within the statute of limitations period. *See, e.g., GRT, Inc.* at *15 ("[T]he presence (or absence) of a survival clause that expressly states that the covered representations and warranties will survive beyond the closing of the contract, although it may act to *shorten* the otherwise applicable statute of limitations, never acts to lengthen the statute of limitations….")